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Regions Financial Corp. (RF)

Credit Suisse Financial Services Forum

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MANAGEMENT DISCUSSION SECTION

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Great. Good afternoon, everyone. Our next presenting company is Regions Financial. We have with us today Regions' relatively newly appointed President, John Turner; and CFO, David Turner. It's been a very busy year of Regions, since we were here last year, at this time with multiple initiatives now underway under the Simplify and Grow banner. This being the case, John and David are going to make some formal comments first and then we'll move to some questions.

One thing you should know is they are not hosting a breakout session. So please consider that, when you think about asking questions between now and the end of our 35 minutes. And so without further delays, let me turn over the podium first to John.

John Turner
President & Head of Corporate Banking Group, Regions Financial Corp.

Excuse me. Thanks, Susan. And good afternoon, everyone. We appreciate the opportunity to participate today. As Susan said, I'm joined by David Turner our Chief Financial Officer and Dana Nolan, our Head of Investor Relations.

And before I begin, just please note our forward-looking statements disclosure including the appendix of our presentation. I want to take a few minutes to give you an overview of 2017 and talk a little bit at a high-level about our expectations for 2018, and then turn presentation over to David.

Just start by reiterating that we're focused on a successful execution of strategic initiatives that we laid out now two years ago. We're particularly focused on can we grow and diversify revenue. Our initiatives that we are contemplating, are they appropriate expenses, and do they help us effectively deploy capital. And I will tell you that we're particularly pleased with our 2017 results, particularly our ability to achieve our profitability objectives.

We earned $1.2 billion in 2017, which was a 9% increase over the prior year. We also earned $1 a share, which was a 15% increase over 2016. We produced pre-provision pre-tax income growth and positive operating leverage of approximately 2%. And keep in mind that these results were impacted by the tax changes and tax reform and so we think they represent particularly solid core net operating performance and we believe that that is sustainable in the future.

We continue to benefit from an asset sensitive balance sheet and a very loyal and stable customer deposit base, had about a 4% impact on net interest income in 2017, and our NIM improved 19 basis points, again because of this asset sensitivity and importantly because of the strength of our very loyal and stable deposit base.

Prudent expense management continues to be another important initiative and we were able to hold expenses relatively flat, they grew less than 1% and that was despite making investments in technology and other revenue generating opportunities, and so we think at this point expense management is clearly a hallmark of what we've been able to achieve. Additionally, we began talking about de-risking our balance sheet, certain portfolios and asset classes now, probably six quarters ago, that had some negative impact on loan growth particularly in the corporate bank. We now feel like that that de-risking activity is about over. But we would point to the improvements in our asset quality as being a real benefit of our focus on de-risking, specifically in the quarter, criticized, classified and non-accrual loans all improved pretty dramatically. And in fact non-accruals improved to a level that we have not seen in over two years. And we believe there's room for continued improvement.

Then finally, we are particularly proud of our focus on customer service. We've won numerous national awards, recognition from companies like J.D. Power and Greenwich Associates for the quality of our customer service, that's led the growth in checking accounts, households, wealth management households, credit card business, assets under management and consumer loans, all fundamental to continuing to grow our business and to continuing to grow revenue.

Also quickly and how we're doing against the financial targets that we established in 2015. We are continuing to make a good progress we believe and intend to achieve the objectives that we set out in 2015, by the end of next year and I'm sure David will talk a bit more about that.

In terms of an economic outlook, we believe it is positive. When you look at our expectations for 2018, our economic assumptions were established in November of 2017 and they serve as the basis for our 2018 plans. Our outlook was predicated on GDP of 2.5%, a modest improvement in global economic conditions and improving labor markets.

Our net interest income guidance utilize market forwards as of November the 20. Our plans imply the – Two Fed Funds rate increases including the one that occurred in December and we had a target of 10-year treasury rate of 250 basis points. So while we acknowledge that market expectations have changed and that would be obvious to all of you, you might think that our assumptions are a bit conservative. We still view the markets is being somewhat volatile. And so we point to that as we think about those assumptions.

Now, Susan mentioned Simplify and Grow and I'll take a few minutes to talk about that. Our industry is going through, we believe real transformational change. Our customers are demanding more faster, more convenience, more channels in ways of doing business with us and we think that that requires that we really redefine the way we do business. We believe that our business is fundamentally sound today as we went through our annual planning process in mid-2017, it occurred to us that we had a good three-year horizon that we believed was going to provide for nice returns. But with all that we saw going on around this, we felt it was important that we began to think about really structurally transforming the business to take advantage of what we believe will be a future opportunities to build a sustainable business, three years, five years and 10 years from now.

And so executive management and our board approved a new strategic initiative which we're referring to as Simplify and Grow. It's about how do we enhance the customer experience, how we accelerate revenue growth, how do we simplify our organization, and our processes to drive efficiency and effectiveness. So I'll be quick to point out, it is not strictly an efficiency initiative. It really is about how we leverage the culture that we have in place today, leverage the commitment to customer service that we believe is a hallmark of our business, to really transform the business in a way that will allow us to be sustainable.

So – we'll also will be organized into four primary categories. First and foremost, is that focus on the customer. How do we develop a digital technology based strategy that will allow us to get things done quicker, faster, easier, whether it be opening accounts, taking applications, originating new loans or other transactions with customers.

We've recently restructured all of our branch roles again taking advantage of technology. We have eliminated teller positions, all of the associates in our branches are now bankers. They can all provide financial education, advice and guidance to our customers to meet their needs and help them achieve their long-term financial objectives.

At the same time, each is still capable of handling the normal transactions that occur within our branch and so far that's been very successful and this helped us reduce head count in our branches over time.

Second, we want to simplify our organizational structure. We need to carefully evaluate spans and layers in our business. All businesses need to go through this process from time-to-time and we're certainly there today. We think that we need to evaluate committees and processes, looking for ways to take steps out to ultimately make faster, better decisions that result in a better customer and banker experience.

Third, we're focused on initiatives that drive revenue growth and leverage technology and innovation, we've got to find ways to bring these initiatives to our customers faster because that's what they require, and we think with Simplify and Grow will certainly help us do that.

And as finally, we'll continue to optimize our channels, our products, our services to better meet customer needs. We intend to continue to review our branch footprint, make sure that it's optimized and look for opportunities to continue to consolidate where necessary. We'll become more efficient and effective by leveraging technology, using robotics and artificial intelligence in certain parts of our business, we've already begun to do some of that and are seeing the benefits.

We've engaged McKinsey to help us, this is not a McKinsey project, it's a Regions project, but we felt the need to engage a partner to help us – continue to push us to bring a perspective about what's possible to help us identify best practices across both the financial services industry and other industries that have transformed themselves and so far we're off to a good start with McKinsey. They've completed a comprehensive review of our business, we're going through the process of evaluating and assessing their recommendations now.

And while some of you have expressed an eagerness to know what does this mean, can you give us a number? It'll be sometime I think before we can do that as we continue to evaluate what our opportunities are. Remember this is – we believe transformative, we want to be careful, we want to be thoughtful, we want to be deliberate as we think about how changes in our business impact our customers, our associates and importantly again the way we do business.

So I'll turn it over to David now, let him talk a bit more about 2018.

David J. Turner, Jr.

Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Thank you, John and good to be with you today. So let's jump into the expectations for loan growth. From a business loan perspective, we remain committed to responsible growth, prudent client selectivity and the judicious allocation of our capital, ensuring that we get appropriate risk adjusted returns and we've spent a lot of last year working through that. We had a lot of deliberate risk management initiatives that were on board last year, asset classes and industries that we worked through and the corporate banking segment in particular and that negatively impacted loan balances.

We are substantially complete with that from a business service standpoint and so that headwind that we were facing we think is pretty much done. As we think about what could help us from a growth standpoint, we do have tax reform, we believe that's incrementally helpful in the interim. There may be more liquidity in the marketplace that works against us from a loan growth standpoint, but we think net-net in the long haul the tax reform will be helpful to us.

We experienced momentum in the second half of 2017 in particular the fourth quarter where our production and pipelines improved and we do expect that to continue into 2018. As we think about consumer, the overall health of the consumer is very strong, even though the amount of leverage in the consumer space is about what it was pre-recession levels the ability to pay that is actually pretty strong.

We did have last year our indirect auto. We didn't renew a contract that cost us a little over $500 million in average balances. That's going to grow this year in 2018 to about $700 million. So excluding the third-party indirect auto we did outperform on consumer, more than our industry and across most of the consumer categories. And based on what we know, we expect that to continue into 2018. So as you think about what this means [ph] for (00:14:27) total growth expectations excluding the third-party indirect auto, expect full year average loans to grow in the low single-digits.

So let's move on to deposits. We continue to believe that, that our deposit base provides a significant competitive advantage. Our deliberate strategy to grow low cost deposits is well on its way. We reduced higher cost, brokered and collateralized deposits and we believe that continues to pay off for us. It is important to note that two-thirds of our deposit base are retail deposits. We have a very loyal customer base. 40% of our retail customer's deposits have been customers of ours for more than 10 years. So as you look at the chart, it illustrates through the current rising rate environment. We've kept deposit costs low. And if you think about deposit betas, ours is very favorable to our peers with the cumulative deposit beta up 10%. So, we expect full year average deposits to grow in the low single-digits, excluding the brokered and higher cost Wealth Institutional Services deposits which we started moving out last year.

So let's talk a little bit about revenue and net interest income, in terms of our net interest income expectations, I'll need to note that that – it's on a non-tax equivalent basis. Lower tax rates reduced the fully taxable equivalent adjustment for tax advantage loans of about $45 million for the year. So what that means is, we'll have this first quarter you will see a reduction in our net interest margin as a result of this reset of about 4 basis points.

In December, we gave you 2018 expectations for net interest income growth of 3% to 5%. And you can see on the slide this highlights the baseline assumptions that are included in that guidance, now we utilize the November market forwards which had – and low single-digit deposit and loan growth and deposit betas that average 40% for the year.

Today, the market is anticipating between two and three rate increases and the 10-year of this morning about 2.84%. So improving market conditions provide an opportunity for us perhaps if we can hold onto the beta to be at the higher end of that range. We believe our deposit beta has been low. If we start getting faster rate increases, we think the deposit beta will move up but nonetheless we believe it to be a competitive advantage for us relative to our peers.

So in the first quarter, we'll have a couple of things happening. We have two fewer days that will reduce net interest income about $10 million and that will cost us about 4 basis points of margin. Oh, I'm sorry but that should increase net interest margin by 4 basis points and then we'll have a one-time reset on margin of 4 basis points going the other way.

So, a lot of noise going on in the first quarter with net interest income and margin, net-net we expect both of those to increase modestly. So, with respect to fee income and expenses, we completed a number of initiatives in 2017 and have several more in process to help us drive revenue and efficiency.

From a fee income perspective, we'll continue to grow core accounts enhanced by the recent launch of our new platform, two new platforms one in wealth management and one in treasury management. We made enhancements to our mobile app, we're rolling out card controls for both debit and credit cards along with facial recognition log-in capabilities.

Our Zelle P2P payment capabilities are launched in the second quarter of 2018 and we have opportunities within our capital markets group to further integrate BlackArch Partners, our M&A advisory business that we purchased some time ago and to continue to grow our capital markets products and services.

In addition, finalizing tax reform should increase the contribution for our low-income housing tax credit syndicator, First Sterling that we bought about 14 months ago, I'll tell you it's been somewhat on ice this past year because of the uncertainty with tax policy. And now we have that we expect that to contribute more in 2018.

On the expense side, we continue to evaluate our Retail Network Strategy. We consolidated 10% of our branches over the last two years and we reduced square footage in the branch – in nine branches by about 4%. We've also as John mentioned redefined our roles in the branches which have and will continue to reduce our branch staffing.

We've created fully digital account openings and loan applications which also will reduce back office functions. We rolled out artificial intelligence in our contact centers in December and have identified other opportunities where AI will create additional efficiencies for us as we move forward. So as we think about 2018 from an expectation standpoint, we continue to expect growth in non-interest revenue of 3% to 6% and that we ought to be able to keep expenses relatively flat.

What that does is – will result in an efficiency ratio of less than 60% even after the tax equivalent adjustment there and we should have a positive operating leverage in the 3% to 5% range and then finally from a tax standpoint, our tax rate was about 31% last year, we think in 2018, it will be somewhere between 20% and 22%.

So let's move on asset quality. We experienced broad-based improvement in 2017 with criticized business service loans decreasing 32% over the prior year and total non-performing loans decreased 35%. So you think about the reduction in non-performers, it was the second best in our peer group. And as John mentioned, this is a level we haven't seen in non-performers in over 10 years. So looking forward to 2018, we expect charge-offs to be in that 35 basis point to 50 basis point range, but based on current market conditions, we expect that we would be at the lower end of that range. From a capital standpoint, as you can see we continue to maintain one of the highest capital ratios in peer group. We talked about a common

and peer group. We talked about a Common Equity Tier 1 target of 9.5% and today we finished at 10.9% on Common Equity Tier 1 on a fully phased-in basis. As we think about capital priorities; first and foremost we want to grow loans appropriately – appropriately priced, appropriate return metrics. Now we want to have an appropriate dividend to our shareholders. We paid out a dividend of about 31% of our earnings to shareholders.

We've espoused a target of being in the 35% to 45% range over time. Now, we do look at using capital for bolt-on acquisitions so things like First Sterling and BlackArch Partners should be examples of what we've done in the past; and mortgage servicing right acquisitions. And then finally, to use our capital we would extend our buyback program that we participate in through CCAR.

So, as we think about returns to our shareholders and to look at the amount of capital we returned last year through our CCAR was $1.47 billion of share repurchases over the past 2 quarters we repurchased $1 billion worth of common stock and declared dividends of $208 million. So we've return more capital as a percentage of earnings than almost anyone in our peer group. But we still have ways to go as we think about getting our Common Equity Tier 1 targets down to about 9.5%.

So as we think about 2018 and beyond there are four key areas that are providing considerable momentum for Regions. First, we are asset sensitive, we continue to benefit from a low-cost deposit very sticky deposit base, low deposit betas. We believe that is a key contributor of our franchise value and a sustainable competitive advantage for us, especially in the rising rate environment.

Secondly, our asset quality continues to improve. We are very happy with the improvement we saw in the fourth quarter, not just in total, but the fact that it was broad-based and that we expect that to continue into 2018.

Next, our robust capital returns. We continue to move towards that 9.5%, so we have a lot of capital to utilize or return to the shareholder as appropriate. And finally, we're going to have some additional efficiencies that we gain through Simplify and Grow. Elements of the Simplify and Grow are in the guidance that we've given you today and before, but there's going to be additional benefits of Simplify and Grow that we will relay to you as they become known.

So, the long-term expectations for us, targets and expectations are as you see printed here. We've discussed each of these with you, they're summarized here for your benefit.

And with that, John and I'll stop. And Susan, we'll enter our Q&A and take some questions. Thank you.

QUESTION AND ANSWER SECTION

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you. So maybe, I'm going to start my questions by going back to the Simplify and Grow initiative that you opened up with John. And you've talked about it being both revenue and almost more revenue-oriented than efficiency-oriented, but marrying the both of these aspects, which is important. And you also mentioned low retail deposit betas, and your deposits are very sticky. Your customer experience scores are very, very good. So, when you think about the end point and where you're going with this, it sounds like this is more forward-looking than catch-up investment, but how do you think about what that end point is?

How do you gauge that on an absolute basis and relative to peers, how do you know if you're getting a step ahead, or you're moving in sync?

John Turner
President & Head of Corporate Banking Group, Regions Financial Corp.

A

Yeah. You know I think it's – it's ever evolving. I'm not sure that we'll ever get to an endpoint. It's hard for us to ever imagine being a leader in technology, so I'm not sure we'll ever get ahead so to speak, we're going to be a close follower, that's been our history. You can see from David's presentation, we've made a number of investments already in technology and digital platforms that help us – impacts our customer experience. I think we'll know how we're doing as we see our growth in metrics like household, checking accounts, cards, card utilization, continues to accelerate and importantly retention of customers improve over time. That will be a proxy for us. But I think it's going to be a continuing evolving experience and we're going to have to pay attention to all the trends in the business.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Sounds about right, in this evolving banking industry. When we think about your investments in the capital markets and I want to tie this in to loan growth broadly and you acknowledge that post-tax reform there's maybe some extra liquidity in the market. And we don't really see much of a pickup in commercial loan demand in the [ph] H8 (00:27:03) data. But what are you hearing from your customers right now and given what capital markets capabilities you do have, how much displacement are you seeing between loan demand into the debt capital markets given just how welcoming they are right now?

John Turner
President & Head of Corporate Banking Group, Regions Financial Corp.

A

Yeah. The third quarter was obviously I think everybody said this a very active quarter as customers did impact the capital markets at an accelerating rate, probably more active than we'd see that in any of the course, over the [ph] prior two or three years (00:27:31). Seeing a little bit of activity in the first quarter but for the most part I would say that it's just been a fairly quiet start to the year.

Our expectation is that we will see more loan growth toward the back half of the year. As we talk to our customers, they are focused on making investments, that they had not contemplated a year ago – two years ago whether it would be in fixed assets or it be an expansion of their businesses or new facilities and their customers likewise are doing the same, because it's important to us to get feedback not only from our customers, but from their customers' customers. And so I do think the marketplace is reacting to tax reform in a positive way. But there are other factors like a tremendous amount of liquidity in the market today that we think are just going to make loans – are going to impact loan growth potentially negatively initially. And so, it'll be more back half loaded. Our expectations are still sort of 2% to 4% for business loan growth and that hasn't changed.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. You acknowledge your conservatism in your interest rate sensitivity outlook with your rate hikes as well as the 2.50% on the 10-year. And I'm right there with you in my model, so I understand that completely and you look at where the 10-year is today, and given where it's been over the last few years it's hard to believe that it will stick. But I'm curious from where you're sitting today, given the macro backdrop it seems like it could stick here for longer. And so, as you manage your securities portfolio, and your liquidity deployment, what changes are you making? Are you deploying more of the liquidity today? Are you contemplating extending duration in any way? How is that changing?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, I would tell you that the – so the tenure being up higher than when we started this is positive. I don't think extending duration right now getting paid for that is what we want to do, I think continuing to gather low cost deposits making prudent loans, we're going to look at our sensitivity, we brought it down just a tad, in the past quarter. As the market continues to provide to us our expectations of where the rate environment should be – what rates ought to be, to give us the kind of margin and return on capital, we will start to bring down that sensitivity.

I don't know that there that we're there yet, there's still some volatility in the market, but you're looking out at the probability of a short-term rate increase of about 88% from March, it's about 55% in June and if I recall 23% in September. So, right now the market's forecasting pretty good rate increases for which we're going to have more pressure on deposit betas. That being said, we should be able to outperform our peers because of our deposit base that we have. So, we are still in 3% to 5% range, I did say if the rate environment stays where it is right now, perhaps we perform at the higher end of that.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Fair enough. Any questions from the audience?

Q

[Question-Inaudible] (00:30:59-00:31:20)

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, it's a good question. So, we will need some preferred issuance today, we are satisfying a Tier 1 requirement with Common Equity is too expensive. We need to trade that out. We've been pretty upfront with that. So we could see something towards the backend of the year. As we think about opportunities today versus what might exist in the market risk that we have to take. Our issue is we just can't stand the negative carry on it right now, so to do something today without being able to use the proceeds to trade out through common equity, just doesn't seem to be in order for us. We still have this thing called the CCAR, we have to go through the process, we'll submit our plan in April or early April and we'll execute from there, but you're right we have $800 million to $1 billion worth of preferred we'll do over time.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

So going back to your rate sensitivity for a minute and potential pressure on deposit betas. Your loan to deposit ratio runs 400 basis points, 500 basis points below your peer group, where do you see that going should it come up to the peer group level, is there a ceiling on where you want to go?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, the ceiling, it used to be we would – we'd take $10 billion out of market overnight and have 100% plus loan deposit ratio and I don't think I would sleep much at night having that. So we're in the low 80s, I think over time you'll see that drift up to perhaps the low 90s. And our – that's really a ratio that is – that's the conclusion of the efforts for us gathering good core low-cost deposits which regardless of where we stand on loan deposit ratio. We want all the low-cost deposits we could get and then we want to take all the good prudent loans we can, but we're not going to force the ratios. We're going to look for the good business to go get, it is what it is. So that being said, we don't want to have an overreliance on wholesale funding like we used to have either.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And speaking of ratios, payout ratios, CCAR, your required capital – your target capital level of 9.5-or-so-percent, [ph] like sort of that (00:33:43) how you set it at 9.5% since that's an awfully healthy cushion above your minimum? I think from where you are today the distance down to 9.5% is still pretty significant, you returned quite a bit more capital in CCAR 2017. How quickly can you get to the 9.5% and why would you hold your minimum at 9.5% when you really could be 100 basis points south of that?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, all good questions. We see – let's where else – I'll start with – that was three questions in one. So we build that 9.5% up by starting at 4.5% Common Equity Tier 1. We had 250 basis points of buffer to get to 7%, so we never want to reach 7% and have our capital plans, dividends and the like to be interrupted.

Now, we didn't layer on, what we think our risk are in our business and so we have done this calculation for some time and we got to – it's actually a little less than 9.5% we rounded it up, and so we're at 10.9%, we have that round numbers $1.4 billion for to get there. What we've said is that our 9.5% when a risk profile was a little riskier than it is today and as our risk continues to come down, you would expect 9.5% to drift down somewhat.

If we layer on more risk, then that 9.5% will go up, but it's a great point to say why 9.5%, it could potentially be a little lower than that, but you're at 10.9% and you're so far away to be that -

[indiscernible] (00:35:22)

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

– on another 50 basis points. Let us get to there, and answer the last part of your question is – as we can get pretty close to that by the end of the year. We can't quite – we don't think we can quite get there, but pretty close. So we'll see, we'll submit our capital plan in the first part of April and we'll go from what our regulatory supervisors tell us, we can go.

Susan Roth Katzke
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Fair enough. We are down to zero on the clock, so I'm going to thank you so much. I will look forward to getting below that 9.5% this time next year.